How to make friends and influence countries

138 – 6 June 2022

Key points

- After the embargo on Russian oil, the policy conversation moves to gas.
- We explore Janet Yellen's "friend-shoring" concept.
- We look at inflation patterns across the Atlantic and pre-view the European Central Bank (ECB)'s Governing Council meeting.

With a deal struck within the European Union (EU) on an embargo on Russian oil, focus is naturally shifting to gas. Policy ideas are emerging around forging "consumer coalitions" to negotiate with suppliers. Setting a maximum price at which operators in the member states could buy natural gas from Russia could be a tempting option for the EU. Gauging the reaction from Moscow to such proposal would not be straightforward though.

Beyond the EU's own efforts, the West is under pressure to unite further. In a speech last April Janet Yellen advocated "friend-shoring" of supply chains to "a large number of trusted countries, so we can continue to securely extend market access [and] lower the risks to our economy, as well as to our trusted trade partners". Raghuram Rajan last week criticized this concept from a "North versus South" point of view, making the point that friend-shoring could entail transacting with countries of similar development levels, which could leave developing and emerging countries unable to continue to benefit from globalization to converge towards the standard of living of mature economies. We explore this further. The West could endeavour to build a sphere of influence including some poorer countries, but it could also be tempted to "give up" on the trade integration of the South for reasons of domestic stability: the rejection of cheap labour competition could help with social tensions at home – even if down the road aggregate growth would be impaired. The geopolitical consequences would be significant. A major difference with the old "cold war" is that at the time, the socialist block was an economic non-entity. Today, China's attraction for developing and emerging countries is real.

We look at inflation patterns across the Atlantic. In our view, the recent convergence is superficial: inflation is less entrenched in Europe than in the US. Still, there might be tentative signs that inflationary pressure is starting to abate in the US and this week's core Consumer Price Index (CPI) release could be interesting. Yet, for now the central banks will remain nervous. We pre-view the ECB's Governing Council meeting. While chances of a 50 basis points hike in July are rising, we think it remains data dependent (the June inflation print could be key). A good reason to stick to 25 basis points – still our baseline – is that the bond market has not yet been tested for the actual termination of Quantitative Easing (QE). It would make sense for the ECB to take the time to assess how market conditions are shaping up before "going for the jugular".

Coalition against coalition?

The EU finally managed last week to overcome its divisions and agree on an embargo against Russian oil. It's imperfect, with a "sunset clause" for pipeline shipments, to placate Hungary, Slovakia, and the Czech Republic, but with Poland and Germany announcing their intent to stop their own imports through pipelines, this leaves only marginally more than 10% of the current quantum of Russian oil arriving in the EU still exempt from the embargo. This will significantly lower Russia's capacity to raise hard currency, as the EU normally absorbs 50% of total oil exports (the equivalent of c.5% of Russian GDP). Indeed, oil is more easily "fungible" than gas and Moscow can find other buyers for it, but the embargo will likely force them to accept another mark down relative to world prices.

Still, Brent price rose in response to the announcement, hitting USD 123/bbl. last Tuesday, the highest level since 22 March, **until Organization of the Petroleum Exporting Countries (OPEC)'s decision to extend a pre-announced increase in production eased back the market.** OPEC will raise supply by 650k barrels a day in July and August, 50% more than what had been originally announced. This won't completely offset the drop in production from Russia (the world's second largest supplier after the US). According to the International Energy Agency, Russia is currently producing 15% less than its target, a gap equivalent to 1.6 million barrels a day. Yet, **OPEC's gesture is important since it reflects a readiness "not to push the envelope too far" and try to reap a maximum financial benefit from the current tension.**

Beyond OPEC's move – in which Saudi Arabia has played a major role – there is a lot of manoeuvring and policy ideas on how to better regulate the energy markets. We already mentioned in Macrocast Mario Draghi's proposal (after a meeting with Joe Biden) to build a coalition of oil buyers to try to offset the market power of cartels such as OPEC. It may be that the Saudis calculated that it was more advantageous to release some additional oil now rather than wait until such coalition emerges. **The same approach may be attempted to deal with Russian gas**, as per a proposal from Italian economist (and advisor to Mario Draghi) Francesco Giavazzi at the Centre for Economic Policy Research symposium in Paris last Thursday. This would "kill two birds with one stone": obtain a quick reduction in wholesale gas prices which would alleviate the inflation shock in Europe and reduce Russia's capacity to fund its war.

A "gas buyer cartel" would have several options to choose from. One would consist in forging an agreement among Europeans around a maximum price – below the current market one – at which they would accept to buy Russian gas. Given the logistical features of the gas market in Europe (a limited number of operators and only a few well-identified outlets for Russian gas on the EU territory), enforcement would be relatively simple. The calculus for Russia would also be simple: either accept a lower price but still get some hard currency through this channel, or reject it, refuse to meet European demand, and get none.

This type of rational, purely economic approach may however be too crude. Russia could react by immediately turning the tap off on the belief that the EU, faced with the reality of a sudden stop in gas imports, would be unable to hold on a unanimous approach. Despite all the efforts of the European Commission, there is as of now no credible plan which could realistically replace Russian gas in the short run. With a "bluff Russian embargo", wholesale gas prices would rise again, pushing inflation further up and adding to the governments' concerns over the possibility to see public opinion turning against them on their stance in the Ukraine conflict. Such "game" could continue for some months. We are entering the summer season and stocks – although far from the 80% capacity usually seen by the end of the autumn which provides security over the winter season – stood as of May 31st at 47.1% of storage capacity, 9.5 percentage points above the level seen a year earlier. The EU would have some capacity to hold its ground as well. Predicting the outcome of such a game would be difficult. Inflation stress and concerns over heating and industrial activity for next summer in the EU would have to be measured against the additional pressure on Russia's finances coming from a sudden stop in gas income from its European clients adding to the effect of the oil embargo.

In another option, the EU would not start by stating a maximum price it would be ready to pay but would seek a negotiation with Russia. Yet, the most powerful incentive we think the Russians would have to accept "on their own accord" to lower the price of gas would be some commitment of the EU to continue buying some Russian gas instead of proceeding with the complete shift away from this source of supply within the next 2 years, as per the Commission's plan. Indeed, Russia would "lose" on the immediate shipments because of the price drop but would secure a long-term client. **While we could see the positive impact of such an outcome on European inflation, this would be completely at odds with the notion of "energy security" which has been the EU's motto since the beginning of the Ukraine war.** Beyond the prolongation of a major source of strategic weakness that such "deal" would entail, this would put the EU in the impossible moral position of accepting to finance "for the long haul" Russia's military efforts in Ukraine and beyond. We fail to see how some of the EU member states' neighbouring Russia could accept such a capitulation.

The limits of "friend-shoring"

Habitual readers of Macrocast are familiar with your humble servant's concern over "deglobalisation" and we explored two weeks ago how the current inflationary pressure could act a reminder of the benefits of free trade. We were intrigued last week by a column by **Raghuram Rajan in Project Syndicate – former Chief Economist of the International Monetary Fund (IMF) and former Governor of the central bank of India – going after Janet Yellen's "friend-shoring" speech at the Atlantic Council in April.**

The US Treasury Secretary had been quite blunt*: "Let's build on and deepen economic integration and the efficiencies it brings—on terms that work better for American workers. And let's do it with the countries we know we can count on. Favouring the "friend-shoring" of supply chains to a large number of trusted countries, so we can continue to securely extend market access, will lower the risks to our economy, as well as to our trusted trade partners".* Rajan reacted to this manifesto from a North versus South angle: *"friend-shoring will typically mean trading with countries that have similar values and institutions; and that, in practice, will mean transacting only with countries at similar levels of development"*. His concern is that friend-shoring ends up reducing the capacity of developing and emerging nations to benefit from their specialization – in particular abundant and cheap labour – to gradually catch up with the mature economies thanks to trade.

To be fair, there is nothing in Yellen's speech which explicitly excluded developing and emerging nations from the "friend-shoring community", and one could imagine a western sphere of influence attracting some non-mature economies. Yet – and this is a key difference with the cold war between the United States (US) and the Union of Soviet Socialist Republics (USSR) – an issue for the constitution of such a sphere of influence is that the economic attractiveness of the West is not what it used to be. From the 1950s to the 1980s, the socialist block could attract developing nations thanks to ideological convergence and the promise of robust military support, but the USSR was a "non-entity" from an economic point of view. Those in the South searching for economic prosperity gravitated "naturally" towards the West. For all its current woes, China's economic attractiveness to emerging and developing nations is strong. Rajan's concern about "friend-shoring" in the West ending up in a "rich countries club" is valid. The benefits to the West of this type of globalization would be less clear than the "all out" globalization underway since the 1990s. If a significant share of the developing world escapes the Wests' sphere of influence and choose China, mature economies would benefit less from cheap imports, a factor which has played a major role in limiting inflation there.

There may be a trade-off though: **public opinion in the West may be more open to free trade within "like-minded countries" of similar development level, as its capacity to alter the social fabric would be limited** (no competition via cheap labour). As we discussed two weeks ago, in the long run this may not be great for aggregate growth in the West, but possibly, reducing the pressure on social structures at a delicate time in the political life of developed nations could be a strong enough temptation in its own right. But dynamically, the more mature economies will focus on their own social stability, avoiding trade with poorer nations, the more China will gain in attractiveness and will have space to extend its own sphere of influence. We collide again with the usual "hegemon's dilemma": maintaining domestic prosperity/social stability and wielding geopolitical power can be contradictory.

Still two inflation stories

While we hope for good news on the energy front, the inflation dataflow continues to fuel the ECB's concerns. Headline inflation hit 8.1% in May, on par with the US (see Figure 1) and what is probably more problematic is that core inflation continues to creep higher (3.8% year-on-year against 3.5% in April) and exceeded expectations for the second month in a row. Inflationary pressure continues to widen, to the point that the tale of "two inflations" across the Atlantic may be in jeopardy. **It may be tempting to just prolong the lines and conclude that European inflation is purely a lagged version of American inflation, but not substantially different** (see Exhibit 2).

Exhibit 1 – Transatlantic convergence on headline inflation

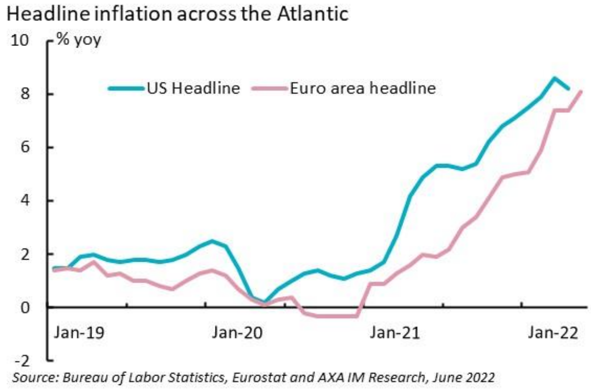
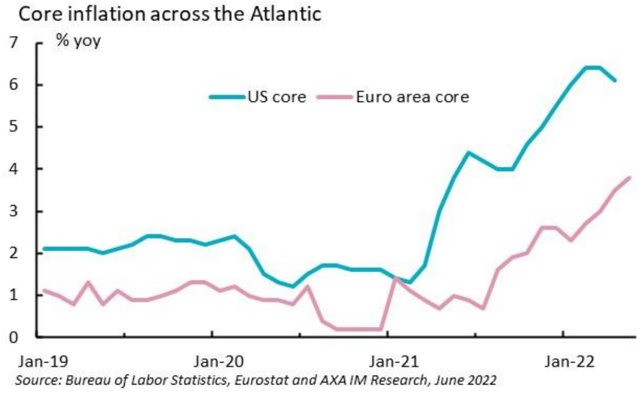


Exhibit 2 – Still significant gap on core though



However, there are still some key differences though when looking at the components of core inflation. While the change in the price of manufactured goods has been very similar across the Atlantic – which makes sense since these heavily internationalized products tend to follow a "global trend" – a major difference still appears on services. This is due in part to the behaviour of rents, which have accelerated markedly in the US while they remain inert in Europe (see Exhibit 3) but also to the lower pressure from wages on the European side (services prices are heavily driven by labour costs). Hawks at the European Central Bank will probably focus on the acceleration in negotiated wages observed in Q1 2022 (the data was released last week) but the year-on-year change is only marginally above the pre-pandemic pace and at 2.8% it is in line with the forward-looking information collected by the ECB. The gap to the US remains significant.

Exhibit 3 – Rents still flat in the Euro area

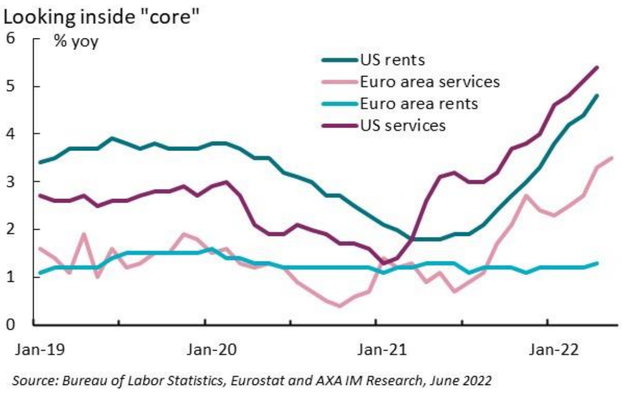
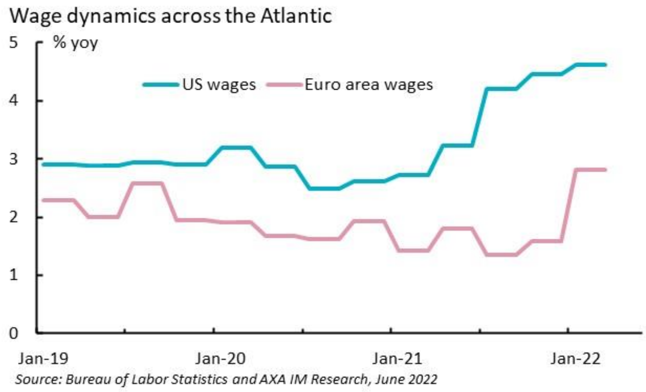
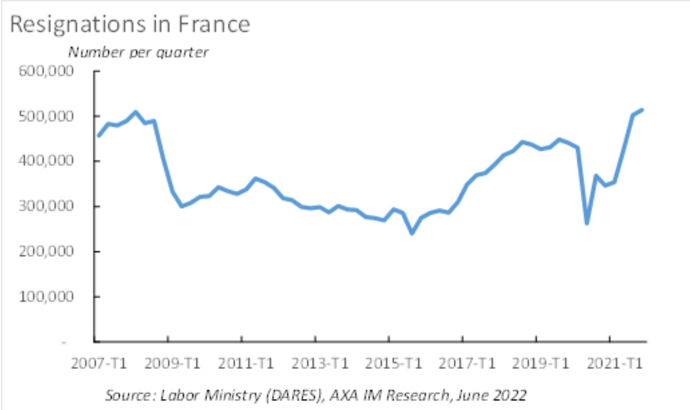


Exhibit 4 – Still significant gap on wage growth



Of course, an issue would rapidly emerge if European wages were to accelerate much further. **Focus on negotiated wages might be misleading, since the US experience would teach us that workers secure pay upgrades more by changing jobs than by getting a raise where they are.** Data on "quit rates" is not as plentiful in Europe as it is in the US, yet French data for instance suggests that indeed a higher-than-normal number of people have resigned (the highest number since the "heady days" of 2007, see Exhibit 5). We need to be prudent though. The data is a bit stale (the most recent is from the end of 2021) and some of it may be purely a catch-up after people had little choice over than "staying put" in 2020-2021 (there was a major decline in resignations at the beginning of the pandemic).

Exhibit 5 – Resignations are up in France – but might be a catch-up



Yet, it might be interesting to see that **even in the US, the country of "big quit", "peak wage growth" might have been reached despite the still strong dynamics in job creation.** Last month we refused to read too much in the below-expectation wage gain in April, down to 3.6% on an annualized basis, given the strong volatility in the monthly payroll data. The replication of this 3.6% pace in May – it stood at 5.8% in March - is a welcome inflexion.

The Federal Reserve (Fed) will want to see "some blood" before changing tack, and some proper deceleration in consumer prices for several months before changing tack, but some of the latest developments are tentatively encouraging. While consumption continues to be strong as we discussed last week, some of the symptoms of overheating which we could see fading in business confidence and housing market data seem to spread to the labour market. The unemployment rate was revised slightly up for April and stabilised in May, while the under-employment rate which covers those in part-time employment looking for more hours rose a tick to 7.1%. If pressure is easing in the US before the Fed needs to use the big guns, the ECB could be more comfortable with its own pre-announced prudent pace. **The release of the US consumer price index for May next Friday could be a key moment.** The market is expecting another slight deceleration in core inflation – 5.9%yoy from 6.2% - but we will continue to look at it excluding the price of used cars (the deceleration in April was entirely due to this single component).

Pre-viewing the ECB

We discussed last week how the conversation at the ECB had become hard to follow with calls for "bigger hikes" to start the normalization process. This week's Governing Council could be the occasion to guide the market, but we see little reason to expect that in just 2 weeks the absence of consensus would have morphed quickly enough into an agreement on a clear mapping of the ECB's next moves.

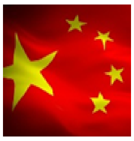
At the very least though, the ECB will have to come clean on quantitative easing. The central bank is likely to formally announce that the Asset Purchase Programme (APP) purchases will stop in the last days of June/early days of July, while maintaining the guidance on the reinvestment, with a small twist. We expect of wording around: *"The Governing Council also intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key ECB interest rates and, in any case, for as long as necessary to maintain favourable liquidity conditions and an adequate (rather than "ample") degree of monetary accommodation.*" We don't expect any change of the guidance on Pandemic Emergency Purchase Programme (PEPP) reinvestments (at least until end 2024, it can be extended at a later stage).

The ECB won't have much to do to prepare the market for a depo rate lift-off in July given the intense communication already directed at investors. Forward guidance will have to formally change though. The current text reads: *"The Governing Council expects the key ECB interest rates to remain at their present levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realized progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilizing at 2% over the medium term.*" This could change to something like *" the Governing Council* *expects the key ECB interest rates to be at higher levels, intending to exit from negative rates by the end of Q3, as long as it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realized progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilizing at 2% over the medium term."*

This is not what the market will be focusing on this Thursday though. What matters is the quantum of tightening which will be delivered in the coming months. In the forward guidance we propose, the first hike in July would be implicitly limited to 25 basis points, which would leave it to September to bring the depo rate into positive territory (although arguably "by the end of Q3" would be semantically consistent with reaching zero in July already). We mentioned last week that the probability of a 50-basis points hike, in reaction to the recent acceleration in inflation, is rising. There is probably still some data dependency around the choice between 25 and 50 basis points. Another scary inflation print for June is probably all that would be needed to go for 50.

There is a strong argument to stick to 25 basis points in July though, and that's why this remains our baseline: for all the "telegraphing", it is still unclear how the bond market is going to react to the effective termination of the purchases. Tension is already visible in Italy, where the 10-year yield has hit 3.40%, with a spread of more than 210 basis points over Bunds. The Governing Council would be right in our view to take the measure of the market reaction before going into stronger action. The tightening in domestic financial conditions is now very real, and the euro's exchange rate – a growing source of concern for the ECB – has moved out of the lows in recent days.

There is however no denying that there is a general appetite at the ECB for proceeding more quickly with a "return to neutrality". A 50 basis points move in September after 25 basis points in July is probably now the "path of least resistance". Yet, we remain of the opinion that the ECB will be "stopped out" by a deterioration in macro conditions before reaching neutrality (i.e., c.1%).

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Labour market report (May) recorded higher than expected non-farm payrolls (390k vs 325 expected). Urate stabilised to 3.6% while earnings consolidated at 0.3%mom (5.2%yoy, -0.3pp) • ISM indices (May) surprised on the upside, highlighting US's economy resiliency. Employment component fell below 50 in both mfg and svcs suggesting slower jobs growth • Consumer confidence edged down at 106.4 from 108.6, still elevated level	• CPI inflation (May) is expected to edge lower, although recent spikes in oil/gasoline will make this a tight call • After big week for labour market data, jobless claims watched for signs of slowdown • Mortgage applications – no real signs of an end to slowdown in housing • Trade balance (Apr) narrowing expected after erratic Q1 movements in exports and imports
	• EU Leaders have agreed on a ban of oil imported from Russia • Euro area flash HICP rose to 8.1%yoy in May, surprising to the upside market expectations	• June ECB Governing Council meeting to formalise pre-announcement of rate hikes for July and September. On the forecast front, 2024 (core) inflation will be key
	• House prices rose 0.9%mom in May contrasting the surprise drop in mortgage approvals in April to 66k – a 2 yr low • Lloyds business barometer rose to 38 from 33 • BRC shop price index rose to 2.8% (May), with food prices rapidly rising by 4.5%	• New car registrations (May) • UK PMIs (May) flash estimates suggested larger than expected drop in output • RICS House price balance (May) • BoE/Ipsos Inflation expectations survey (Jun)
	• Labour market data (Apr) improved with Urate at 2.5% (-0.1pp) • IP (Apr) came below expectations (-1.3%mom) • Retail sales (Apr) showed signs of moderation, expanding by 0.8%mom vs 2% in Mar	• Households spending survey (Apr) to refine retail sales data last week • GDP revision (Q1) • Economy Watchers Poll (May) • Corporate Goods price (May)
	• The NBS manufacturing and services PMIs improved in May on subsiding Omicron wave. Meanwhile, the Caixin manufacturing PMI showed moderation of the pace of decline	• Activities should continue to improve in Shanghai as it exits 2-month citywide lockdown
	• CB: Hungary hiked rates by +50bp to 5.9% • May CPI to 3.5% in Indonesia, +73.5% Turkey • PMI survey weaker CEE, rather good in BRIC • Q1 GDP +8.4%qoq sa, +4.1%yoy in India; +7.3%yoy Turkey; Brazil • Korean parliament's first extra budget (~3.2% GDP) under the new president Yoon	• CB expectations: India (+50bp), Chile/Peru /Poland (+75bp), Russia (-100bp) • May CPI figures across EM: Thailand, Taiwan, Philippines, Hungary, Russia, Romania, Brazil, Mexico, Colombia • Q1 GDP to be released in South Korea (2nd estimate), South Africa, Romania

Upcoming events		
	US :	Tue: Case-Shiller & FHFA house price indx (Mar), Chicago PMI (May), Conference Board consumer confidence (May); Wed: Mfg PMI (May), ISM mfg indx (May), JOLTS job openings (Apr), Fed's Beige Book; Thu: ADP employment change (May), Weekly jobless claims (28 May), Non-farm productivity (Q1), ULC (Q1), Durable goods orders (Apr), Factory orders (Apr); Fri: Non-farm payrolls (May), Employment data (May), Services PMI (May), ISM non-mfg indx (May)
	Euro Area:	Mon: EU19 Business confidence (May); Ge & Sp HICP (May,p), Ge CPI (May,p); Tue: EU19 CPI (May,p), Ge Unemployment (May,p), Fr & It GDP (Q1), Fr & It HICP (May,p), Fr Consumer spending (Apr); Wed: EU19 Ge & Fr Mfg PMI (May), EU19 Unemployment (Apr), Ge Retail sales (Apr); Thu: EU19 Producer prices (Apr); Fri: EU19 Composite & services PMI (May), EU19 Retail sales (Apr), Fr Industrial production (Apr)
	UK:	Tue: Lending data (Apr), Money supply- M4 (Apr); Wed: Mfg PMI (May)
	Japan:	Tue: Industrial production (Apr,p)
	China:	Tue: Official mfg & non-mfg PMI (May); Caixin mfg PMI (May)

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